STATEMENT OF

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BEFORE THE

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SUBCOMMITTEE ON RAILROADS

HEARING ON

THE STATUS OF RAILROAD ECONOMIC REGULATION

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On behalf of the members of the Association of American Railroads, thank you for the opportunity to appear here today to discuss issues related to freight railroad regulation. AAR members account for the vast majority of freight rail mileage, employees, and revenue in Canada, Mexico, and the United States.

Overview

The economic prosperity of the United States and our ability to compete effectively in the global marketplace depend on the continued viability and effectiveness of our freight railroads. Today, the more than 550 U.S. freight railroads account for 42 percent of the nation's intercity freight ton-miles — more than any other mode. Over a network spanning some 142,000 route miles, U.S. freight railroads connect businesses with each other across the country and with markets overseas. Our freight railroads are a vital link to our economic future.

The current system of economic regulation of U.S. railroads — put in place by the Staggers Rail Act of 1980 — relies on competition and market forces to determine rail rates and service standards in most cases, with maximum rate and other protections available to rail customers who truly need them. This approach, which substantially diminished more than 90 years of failed government regulation, strikes a reasoned balance between providing railroads the freedom to compete effectively in the marketplace and protecting shippers from abuse of railroad market power in the limited cases where railroads do not face effective competition. I respectfully submit to you that the benefits of the current regulatory system — for the railroads, their customers, and the nation — are far too great to be sacrificed in favor of a return to excessive government regulation, which would cause immense harm by preventing railroads from making the massive investments they need year after year to meet the freight transportation needs of our nation

Specifically, H.R. 2924 and its companion bill in the Senate (S. 919) — the so-called "Railroad Competition Act of 2003" — represents exactly the wrong approach to sound economic regulation of railroads. The legislation re-injects government control over wide areas of freight rail operations. It is based on misunderstandings or misrepresentations regarding the extent of the competition railroads face. And most importantly, it dooms freight railroads to a state of perpetual capital starvation. By preventing railroads from earning enough to sustain their systems, this bill would inexorably lead to deteriorating rail infrastructure, declining rail service, fewer rail jobs, and eventually the loss of rail service completely on an increasing number of rail lines. Such an outcome is not what our nation needs or deserves.

It can be avoided, though, by maintaining the successful deregulatory system ushered in by the Staggers Act.

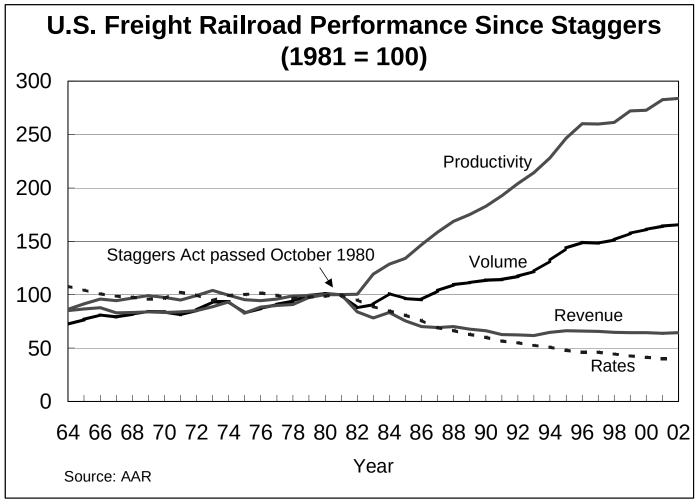
Railroads Since the Staggers Act

Before I explain in detail why excessive regulation in general and H.R. 2924 in particular is so pernicious to railroads and to our nation, it is important to dispel the myth that "…the business model that [railroads] have followed since 1980 … does not seem to have been successful."[1] Consider:

- Rail intercity freight market share (measured in ton-miles) has been trending upward over the past 15 years, after decades of steady decline prior to Staggers.

[1] "The Truth About Railroad Claims of Re-Regulation and Their Fear of Competition," prepared by Consumers United For Rail Equity, July 11, 2003.

- Prior to Staggers, railroads lacked capital to properly maintain their tracks. More than 47,000 route-miles had to be operated at reduced speeds because of dangerous track conditions, and the amount of deferred maintenance was in the billions of dollars. Through 2003, Class I railroads alone have been able to spend well over $320 billion since Staggers on infrastructure and equipment, and rail infrastructure investments per mile of road have risen some 28 percent in inflation-adjusted terms. Today, the Class I freight rail network is in better overall condition than ever before.



- Rail productivity rose 183 percent from 1980 to 2002, compared to 10 percent in the comparable pre-Staggers period.
- Nearly all of these productivity gains have been passed through to rail customers (including proponents of S. 919/H.R. 2924) in the form of sharply lower rates — down 60 percent in inflation-adjusted terms from 1981 to 2002 — saving shippers, and ultimately all of us, billions of dollars per year.

Numerous studies have confirmed the sharp drop in rail freight rates. For example, a June 2002 U.S. General Accounting Office (GAO) report analyzed rail rates from 1997 to 2000. The GAO found that "From 1997 through 2000, rail rates generally decreased, both nationwide and for many of the specific commodities and markets that we examined."[2]

The GAO noted that "[t]hese decreases followed the general trend we previously reported on for the 1990-1996 period and, as before, tended to reflect cost reductions brought about by continuing productivity gains in the railroad industry that have allowed railroads to reduce rates in order to be competitive." In a December 2000 report, the Surface Transportation Board (STB) found that "inflation-adjusted rail rates have fallen 45.3 percent" from 1984 to 1999. The STB also observed, "It is important to note that all types of rail customers, and not just those with competitive transportation alternatives, must have received some portion of the rate reductions we have measured here."[3]

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[2] U.S. General Accounting Office, Changes in Freight Railroad Rates from 1997 Through 2002, June 2002.

[3] Surface Transportation Board, Rail Rates Continue Multi-Year Decline, December 2000.

- The rail accident rate has fallen 68 percent since Staggers, and the employee injury rate is down 74 percent. Prior to Staggers, rail safety was generally worsening.
- Rail traffic volume (measured in revenue ton-miles) is up more than 60 percent since Staggers, far higher than comparable pre-Staggers traffic growth.
- By the 1970s, virtually every major railroad in the Northeast, including the giant Penn Central and several major Midwest railroads, had filed for bankruptcy. Most other railroads were financially weak. Since Staggers, railroads have improved their financial performance considerably, though as a whole they still fall well short of earning their cost of capital.

This is not failure by any definition. Thanks largely to the deregulatory structure instituted by the Staggers Act, the U.S. freight rail system today is universally recognized as the best in the world. From a public policy viewpoint, it makes no sense to make fundamental changes to a system that has delivered such large, widespread benefits.

Railroad Market Power

Proponents of more extensive regulation of railroads typically maintain that the only competitive force that matters is rail-to-rail competition, and that service to a shipper by a single railroad is equivalent to monopoly power by the railroad over the shipper. This view overlooks the fact that railroads face extensive competition for the vast majority of their business, including cases where a shipper is served by only one railroad.

Railroads compete not just among themselves, but in the larger market for freight transportation services. Most shippers, including most of those served by only one railroad, are able to negotiate competitive rates for rail service. Shippers' considerable market leverage results from a combination of powerful competitive forces. It is unreasonable to pretend that these forces do not matter. These forces include:

- *Intermodal Competition*. Shipment via trucks, barges, or pipelines is a competitive option for most rail customers. Though railroads currently account for 42 percent of total intercity ton-miles, they receive less than 10 percent of intercity freight revenue. The rail revenue share has been trending downward for decades — a trend hardly indicative of excessive market power.

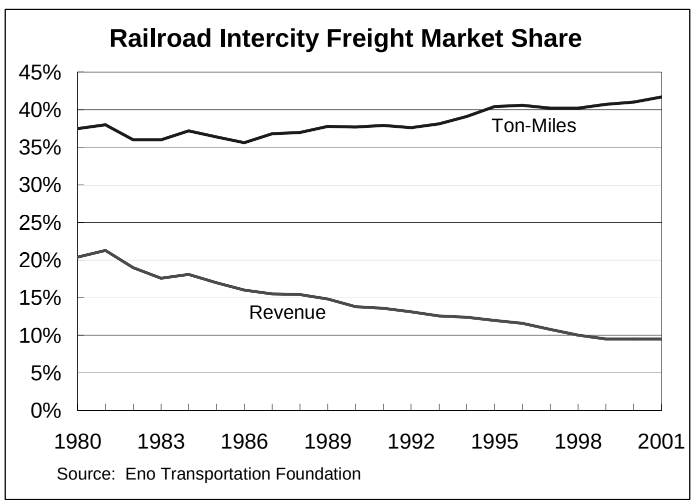
Railroads face significant competition from other modes even for commodities that some claim are "captive" to railroads. For example, U.S. Department of Agriculture figures indicate that trucks are the primary transportation mode for grain, and the chemical industry's own statistics show that railroads account for just 20 percent of chemical tonnage that is transported.

- *Product Competition*. Since the demand for rail services is derived from the demand for the products of rail customers, competition faced by rail customers in downstream markets often constrains railroad pricing.

  For example, the rates railroads can charge for hauling coal to electric utilities must be low enough to keep the electricity generated from the coal competitive, or utilities will generate (or purchase) electricity from sources other than coal. This end-product competition exerts substantial pressure on railroads to keep prices as low, and service offerings as appealing, as possible.

  If a shipper has the option of substituting different products for those that require rail service, then the shipper can use this product competition to constrain rail rates. For example, if railroads attempt to raise soda ash rates too high, manufacturers of phosphate feeds and fertilizers can substitute caustic soda — which can easily move by truck — for the soda ash.

- *Geographic Competition*. The ability of many railroad shippers and consignees to obtain the same product from (or ship the same product to) a different geographic area also constrains rail pricing. For example, a poultry producer in, say, North Carolina can play a railroad delivering feed to it from Ohio off against local feed producers. Likewise, a railroad serving a Louisiana plastics facility must price its transportation service at a level that makes the plastics produced at that facility competitive at destination compared to plastics sourced from different states — or different countries — and transported by other carriers or modes.



  If a railroad that serves a particular facility prices its movements or limits its service offerings in such a way as to render what is produced there uncompetitive with products made elsewhere, the railroad would lose the traffic entirely. Since such an outcome is contrary to the best interests of the railroad, a railroad will do whatever it reasonably can to avoid it.

- *Countervailing Power*. Many railroad customers are large industrial shippers with multiple plants and multiple products, some of which are served by other railroads and/or modes. These shippers can obtain price or service concessions by shifting or threatening to shift traffic among plants, causing the railroads that serve them to compete against each other or the other modes serving the plants.

For example, significant consolidation among electric utilities in recent years increasingly permits bundling the traffic of many plants into one large "package." A utility with such a package can enhance its leverage for service to all its facilities, including those served by a single carrier. The threat of losing the business is likely to generate price or service concessions by a railroad wanting to keep or win the contract, or to expand its current or future traffic volume. In recent years, consolidation in many other industries such as chemicals, coal, forest products, and steel has improved shippers' bargaining power over railroads.

It is not unusual for a single customer to account for a large percentage of a particular railroad's revenues, especially within a specific commodity category. This relative importance and threatened loss of railroad revenues substantially increases the likelihood that a particular rail customer will be able to successfully exercise countervailing power in its negotiations with rail carriers.

- *Plant Siting and Long-Term Contracts*. Shippers can generate competition between railroads before a plant is built by considering transportation options and negotiating favorable contracts when evaluating potential plant locations. For example, rail access was an important consideration for Toyota when it recently decided where to locate a new U.S. auto plant. Moreover, over the long term, shippers can locate or relocate plants on the lines of different railroads.

- *Technological, Regulatory, or Structural Change*. Potential changes in the technology, regulation, and/or structure of a shipper's industry over time could provide leverage over railroads. For example, the siting of agricultural processing plants in or near production areas reduces demand for rail transportation and increases pressure on railroads to remain competitive.

Moreover, rail-to-rail competition today is vigorous, with rail customers constantly searching for ways to increase it, using connections to competing carriers (sometimes through a switching carrier) or establishing (or credibly threatening to establish) new connections through "build outs" of rail track.

For example, the Burlington Northern and Santa Fe Railway (BNSF) and a group of chemical shippers are moving forward with plans to build a new 13-mile line which would connect numerous major plastics and chemical-producing facilities in Houston with BNSF's network. The facilities, which ship thousands of rail carloads per year, are now served solely by the Union Pacific Railroad (UP). And according to recent press reports, United Parcel Service (UPS), which may be the single largest customer of the U.S. freight railroad industry, recently reportedly transferred significant traffic that had been moving on BNSF to UP instead. These examples are not anomalies. Rather, they are indicative of the way that railroads compete against each other all over the country.

Proponents of more extensive regulation of railroads also object to the railroads' use of "differential pricing," Indeed, some wrongly believe that the ability to price differentially is itself indicative of excessive market power. Like businesses throughout the economy, railroads price their services on the basis of demand: shippers with the greatest demand for rail service pay higher margins than shippers with lower demand. At first blush, differential pricing may seem unfair or harsh. In fact, though, it is the fairest, most-pro-efficiency, and most pro-competitive pricing system consistent with the continued functioning of the rail industry. All shippers, *including* those who pay a higher markup, benefit from differential pricing because it maximizes the number of shippers using the rail network and, therefore, maximizes the number of shippers who make contributions to railroads' huge fixed and common costs.

What Would H.R. 2924 Actually Do?

Railroads do not fear competition, including rail-to-rail competition, as long as it is the product of free-market forces. Unfortunately, H.R. 2924 would artificially manufacture rail-to-rail competition through increased railroad regulation.

Through a variety of provisions, H.R. 2924 would use the power of government to force down rail rates for certain shippers at the expense of other shippers, rail labor, rail stockholders, and the public at large. In doing so, it would transfer billions of dollars per year from the rail industry to favored shippers. If this happened, our nation's freight railroads — who already offer the world's lowest rates and lag most other U.S. industries in terms of profitability — would be doomed to inadequate earnings, unable to make the massive investments required year after year to meet our nation's rail transportation needs. Over time, unless taxpayers stepped in with a bailout, freight service over many rail lines would simply disappear. Highways would become more overcrowded and costly to build and maintain, environmental degradation would rise, safety would deteriorate, and shipping costs would rise. Policymakers should not let this happen.

Five major provisions of H.R. 2924 are discussed below. *Each* of them would involve a substantial increase in government regulatory control over the rail industry. Together, they threaten the very existence of freight railroading as we know it in this country. For this reason, the legislation and all its provisions should be rejected.

A. "Bottleneck" Policy

A central element of H.R. 2924 is a provision that would overturn the STB's "bottleneck" policy. Bottleneck cases are those in which only one railroad (the "bottle-neck" carrier) serves either an origin or a destination, but multiple railroads serve the remaining route. Proponents of H.R. 2924 present the false image that most rail shippers enjoy full two-railroad competition from origin to destination. In truth, a very large proportion of rail shippers are served by just one railroad. Therefore, bottleneck policy has enormous significance for railroads.

Existing bottleneck policy is the result of court decisions going back to the 1920s and regulatory precedent going back even further:

1. As common carriers, railroads must provide rates and routes to move traffic from an origin to an ultimate destination.

2. Railroads cannot refuse to use multiple-railroad routes that are reasonably more efficient than their own single-line routes.

3. Absent a significant disparity in efficiency, however, a railroad does not have to "short haul" itself by moving traffic just to a junction with another railroad if it can move the traffic all the way to the ultimate destination.

4. A railroad is not required to provide a shipper with a separate rate for a segment of a through movement.

5. The rate for a through movement can be challenged for reasonableness under existing maximum rate regulation, and the reasonableness test is based on the cost for the entire through movement.

H.R. 2924 would overturn existing bottleneck policy in every major respect. Upon shipper request, a bottleneck carrier would be required to short-haul itself — *i.e.*, provide a rate for a movement to, and interchange traffic at, any junction with another railroad the shipper so designates. The rate for the short-haul segment would be subject to maximum rate regulation based on the stand-alone cost of just that segment, while the rate of the non-bottleneck segment would be driven down toward variable cost.

By effectively capping rates on segments of a through movement, the new bottleneck policy would ordain that railroads would not be able to cover their full costs or replace their assets over time. The shipper would pay a lower rate, but it is a fallacy to claim, as proponents of H.R. 2924 do, that the rate reduction is the product of more competition. Rather, it is the product of more regulation, and it is not sustainable.

Extended over the entire U.S. rail network, this provision could be expected to lead to a revenue loss to railroads of more than $4 billion per year.[4] No one has convincingly explained how such an enormous revenue shortfall could be recouped, or how, in the face

[4] Based on the 2001 STB Costed Waybill Sample. If in 2001 the rates for all traffic affected by regulation had been held to a revenue-variable cost ratio of 180 percent, the railroads would have received $9.2 billion in revenue instead of $13.4 billion, a revenue loss of $4.2 billion (with no associated reduction in expenses).

of such a huge revenue loss, the rail industry could continue to make the massive investments required year after year to meet our nation's current and future freight transportation needs. H.R. 2924 dooms the rail industry to a *non-competitive* outcome that is clearly at odds with the needs of our nation.

The bottleneck provision of H.R. 2924 would have other serious negative effects:

- It would lead to an explosion in regulatory proceedings and in costly behavior oriented toward regulatory ends.
- It would compel railroads to splinter traffic over hundreds of interchanges at the direction of shippers, since shippers would be able to dictate to railroads the location of interchanges. This would constitute a return to the "open routing" that characterized the pre-Staggers era and would reverse the substantial progress railroads have made since then in creating a streamlined, efficient nationwide network.

B. Terminal Trackage Rights and Reciprocal Switching

Existing law provides that the STB "may require terminal facilities … owned by a rail carrier … to be used by another rail carrier" and "may require rail carriers to enter into reciprocal switching agreements" if the STB finds either measure "to be practicable and in the public interest."

In a series of decisions, the STB — and the Interstate Commerce Commission (ICC) before it — have consistently required that the owning carrier first be found to have engaged in anti-competitive conduct before granting terminal trackage and reciprocal switching rights. This ensures that in STB access cases, like comparable court antitrust cases, relief is predicated on actual competitive conditions and marketplace demand, rather than simply on regulatory intervention on request designed to promote artificial competition. The mere fact that the incumbent is the sole railroad serving a shipper, or that the incumbent chooses not to grant another carrier access, or prices differentially, has never been considered a competitive abuse in this context.

H.R. 2924, though, would upset this structure. It would force the STB, upon request by a shipper, to order railroads to enter into reciprocal switching agreements and provide terminal trackage rights. If, as is likely the case, the railroads involved cannot agree on access terms, government regulators would set them, including the access fee. The proposed legislation explicitly eliminates the requirement that a railroad must have engaged in anti-competitive conduct before such action could be mandated.

This provision could be interpreted as mandating terminal trackage rights and reciprocal switching whenever it was operationally feasible — thereby essentially creating forced access on demand in terminal areas. As in the bottleneck provision discussed above, the purpose of this provision is to obtain lower-than-market rates by artificially manufacturing rail-to-rail competition in ways beyond what a competitive market could justify.

Meanwhile, regulators would be inundated with unwarranted requests from shippers to grant terminal access. Moreover, regulators would need to step in to resolve myriad disputes covering priorities for use of track, operating conditions, and a host of other issues. Complex, lengthy, and costly disputes over terms of use would be inevitable as government interference replaced direct negotiation among railroads and shippers and between railroads. In addition, the complexities involved in coordination between track owners and operators could have significant safety ramifications.

C. Final Offer Arbitration

Under H.R. 2924, railroad rate and service disputes could be subject (at the shipper's sole discretion — the railroad would have no choice in the matter) to binding "final-offer arbitration" (FOA).

The FOA process would be completely outside the STB's jurisdiction. An arbitrator's decision could be completely divorced from regulatory precedent and sound economic principles — an unacceptable condition in any case, but especially in the rail context in which "final offers" could differ by millions of dollars. Moreover, there would be no requirement that an arbitrator take into account the existing statutory requirement that regulators recognize that "rail carriers shall earn adequate revenues."[5]

Railroads know of no other case in which private-sector suppliers of a good or service are forced by the federal government to use binding arbitration to set a price just because the purchaser desires a lower price. It is no more valid for the government to force binding arbitration on railroads than it is to force it on chemical companies, plumbers, supermarkets, or any other business.

This provision too is a frontal assault on railroads' use of differential pricing because it directs arbitrators to base rate decisions in many cases on rates paid by rail customers in the most intensely competitive markets. By definition, these markets have the lowest rates. But a railroad must have a sufficient mix of low-demand, low-margin and high-demand, high-margin shippers to cover its huge common and fixed costs. By using regulatory strictures to eliminate railroads' high-margin traffic and effectively cap rail rates, this provision of H.R. 2924 also dooms railroads to a perpetual inability to cover costs.

Today, railroads and shippers can (and sometimes do) voluntarily agree to use binding arbitration if both parties deem it desirable. There is a huge difference, however,

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[5] 49 U.S.C. 10701 (d)(2)

between the voluntary use of binding arbitration and a mandate forced on private businesses by the power of government. In addition, the rail industry has suggested ways to make rate cases quicker and less costly to resolve, while retaining the use of sound, well-established economic principles as a basis for decisions.

D. "Areas of Inadequate Rail Competition"

In a provision of striking scope, H.R. 2924 proposes that the STB designate a state or any part of a state to be an "area of inadequate rail competition" if any of a variety of criteria are met. The criteria used to define these areas are so broad and vague that all or most of the country would qualify — an absurdity on its face, given the intensity of competition railroads face for the vast majority of their traffic. In "areas of inadequate rail competition," government regulators could assume control of huge areas of rail operations. For example, regulators could:

- Control current and future rail rates;
- Force an owning railroad to allow another railroad access to its tracks where it could "cherry-pick" traffic;
- Force an owning railroad to carry freight to a junction with another carrier at a rate set by a regulator.

Regulators would be expressly prohibited from considering whether railroads engaged in any sort of anti-competitive conduct before ordering these actions.

Railroads are open to ways to improve the existing regulatory regime. However, a return to heavy-handed government regulation — as dramatically exemplified by the concept of "areas of inadequate rail competition" — is anything but an improvement.

E. Interchange Agreements ("Paper Barriers")

Since passage of the Staggers Act, Class I railroads have spun off tens of thousands of miles to local or regional railroad operators whose lower costs and closer ties to their customers and communities enable them to operate at a profit where Class I railroads could not. These new carriers have preserved rail jobs and rail service — often in rural areas — that otherwise would be lost.

At the time of some line sales, the parties involved voluntarily agreed to a lower sales price in exchange for an agreement by the new railroad to interchange future traffic solely or largely with the selling railroad. In effect, the purchase price included a cash component and a future carload component. H.R. 2924 would prohibit future line sales from including these types of agreements (sometimes called "interchange agreements" or "paper barriers"), thereby prohibiting interested parties from voluntarily using a legitimate tool that has helped preserve rail service on a significant number of rail lines. It would become more difficult for buyers to purchase and keep marginal lines in operation, since their up-front costs would increase. As a result, an increasing portion of the rail network would likely lose rail service entirely through abandonment, rather than have it transferred to short line carriers.

Moreover, H.R. 2924 would allow the STB to declare interchange agreements more than ten years old to be null and void. This would constitute blatant government interference in the sanctity of private contracts — akin to the government deciding that the price someone sold his house for ten years ago was too high and ordering him to rebate some of the sales price to the buyers. It is another example of a provision in the legislation that proponents would never support if applied to their own firms, but are willing to subject railroads to.

Does H.R. 2924 Reregulate Railroads?

For all the reasons discussed above, it is beyond serious dispute that H.R. 2924 would substantially increase government control over freight rail operations in numerous ways — as good a definition of reregulation as any. The ways that government control would be increased are not just minor intrusions into rail affairs. If enacted, they could be expected to lead to the transfer of billions of dollars of rail revenue each year to favored shippers.

Proponents of H.R. 2924 do not even try to explain how railroads would be able to recoup this revenue, or how railroads could possibly make the huge ongoing investments they need in the face of the capital starvation they would confront. Instead, proponents of the legislation simply claim "there must be a way"[6] for railroads to remain financially healthy under the legislation. Given how critical freight railroads are, claiming "there must be a way" is not good enough.

In our economy, firms and industries must produce sufficient earnings or capital will not be attracted to them. The electric utility industry understands this. In the wake of the huge blackout that struck the Northeast, the Midwest, and Canada last August, the electric industry's major trade association suggested that "FERC and the states should utilize innovative transmission pricing incentives, including higher rates of return, to attract capital to fund needed investments in transmission…[T]he amount of money that FERC [currently] allows investors to earn on transmission facilities still is not in line with

[6] "Draft Reply to Railroad Letters," June 20, 2003, prepared by supporters of S. 919/H.R. 2924.

what they can earn on other investments."[7] Utilities recognize that "the rate of return that regulators allow for investments in new and augmented transmission facilities must be high enough to be competitive with investors' other options for using their money or sufficient investment funds will not be forthcoming."[8]

The chemical industry understands this too. For example, Dow Chemical's basic long-term financial goals include earning a 20 percent return on equity, earning 3 percent above its cost of capital across the business cycle, and earning the cost of capital at the trough of the business cycle.[9] Degussa, a major global chemical firm with substantial U.S. operations, states that "our aim is to generate a return on capital employed (ROCE) two percentage points above our cost of capital as derived from the capital market."[10] BASF, the world's largest chemical company, notes, "Only profitable growth will give us an edge in the international competition for capital.… In all areas we want to earn our cost of capital — and a premium on it too." [11]

Railroads agree with this sentiment. Without the ability to cover total costs and earn an adequate return, railroads — like electric utilities, chemical companies, or any other firm — would be unable to maintain (much less increase investment in) their

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[7] Edison Electric Institute, "Five Steps That Would Help Assure That We Have the Reliability Standards and the Transmission Capacity We Need Going Forward," August 19, 2003.

[8] Stanford L. Levin, "Electricity Competition and the Need for Expanded Transmission Facilities to Benefit Consumers," prepared for the Edison Electric Institute (September 2001), p. 15.

[9] Presentation by J. Pedro Reinhard, Dow Executive Vice President and Chief Financial Officer, to the Lehman Brothers Global Chemical Industry Leaders Conference, April 3, 2003.

[10] Heinz-Joachim Wagner, Member of the Management Board of Degussa AG, Statement at the Financial Press Conference on March 9, 2004.

[11] BASF Strategy and Value-based Management, BASF Financial Report 2003, p. 17.

infrastructure and equipment, resulting in deterioration and/or shrinkage of the national rail system. That is exactly what H.R. 2924 would do. The legislation ignores the fundamental point that rail competition is enhanced only when the railroads are healthy, not when their earnings, which are already substandard, are severely and artificially restricted. If H.R. 2924 were enacted, the already large gap between the rail industry's cost of capital and its return on investment would only widen — taking railroads farther away from the financial performance that proponents of the bill, including some of the firms in the electric utility and chemical sectors, expect from their own businesses.

Does H.R. 2924 Cap Railroad Rates?

H.R. 2924 does not have a provision that *directly* caps rail prices at a certain level — *e.g.*, so many cents per ton-mile — but the legislation caps rates, just the same. After all, the whole purpose of H.R. 2924 is to use the power of government to force railroads to charge lower rates, and it does so in a variety of ways. For example:

- The provision overturning existing rail "bottleneck" policy would have the effect of capping the rate for a typically small part of a through movement at stand-alone cost and the rate for the rest of the movement at a much lower level. The net effect would be a revenue loss to railroads of up to several billion dollars per year.
- Like the bottleneck provision, the provision ordering the STB to grant terminal trackage rights to another carrier upon shipper request would artificially manufacture rail-to-rail competition is ways beyond what a competitive market could justify. The purpose is to obtain lower than market rail rates.
- The final offer arbitration provision mandates that arbitrators base rate decisions in many cases on rates paid by rail customers in highly competitive markets. By definition, these markets have the lowest rates. Therefore, for all intents and purposes, this directive to arbitrators functions as a cap on rates.
- Similarly, rates paid by rail shippers in "areas of inadequate competition" would be based on rates paid by customers in highly competitive markets, further effectively capping rail rates.

These limitations on rail rates would doom railroads to woefully inadequate earnings. Rail disinvestment would be sure to follow, since railroads and their capital providers would not be interested in committing funds to investments if they could not have a reasonable chance to capture the economic benefits of those investments.

Rail Labor Opposes Railroad Reregulation

Since railroad reregulation would prevent railroads from earning sufficient revenues to maintain their systems, and the inevitable consequence would be a shrinking rail network, disinvestment, and lower rail employment and wages, rail labor opposes legislative proposals to reregulate the rail industry. In fact, representatives of unions accounting for more than 70 percent of unionized rail labor have written to Congress in opposition to H.R. 2924. They write that "Any further shifting of the regulatory balance toward shippers would result in greater job losses and wage and benefit suppression. Large corporations who ship by rail may receive financial benefits from these bills but it would come at the expense of many hard working American families in the form of financial loss, the loss of health care and retirement benefits."

The Financial Community Opposes Railroad Reregulation

The financial community, on whom railroads depend for access to the capital they need to operate, has consistently supported the view that, under reregulation, an era of capital starvation and disinvestment would return. For example:

- In a submission to the STB in October 1996, a group of nine investment bankers and securities analysts wrote, "A move toward re-regulation that would cause a substantial reduction in rail revenues would sharply curtail the railroads' access to capital on reasonable terms, and would be a most unwise and short-sighted decision…If rail rates are more heavily regulated…the ultimate result will be that shippers and the public will suffer."

- In April 1998, Stephan C. Month of Credit Suisse First Boston, a global investment bank, testified to a House Subcommittee that "the greater the limitations on the [rail] industry's ability to grow revenues and cut costs, the costlier Wall Street funding will become and…the more difficult it will be for the railroads to earn their cost of capital and remain economically viable."

- In September 1999, Anthony Hatch, a prominent independent Wall Street analyst, noted that "Capital flows to the areas of highest return. If … new [rail] regulations change the rules of the game and ensure poor returns, then the Street will disinvest … causing managements to begin to reallocate cash and begin "harvesting" the business. They will have no choice."

- In testimony to the Senate in May 2001, Morgan Stanley's James Valentine, another prominent analyst, cautioned that rail customers "need to be careful what they wish for, as their efforts to drive rates lower will likely only cause more capital to leave the industry and service to deteriorate."

- In January 2004, John Barnes of Deutsche Bank warned, "In the beginning, there would be short-term benefit [from reregulation] for captive shippers through lower rates. However, instant gratification usually comes with a headache the next morning, and there would be no Advil strong enough for the long-term damage associated with railroad re-regulation…[O]ver the long-term, everyone would share in the hangover: shareholders, customers, railroads, the entire transportation system, the U.S. and global economies. In the worst case scenario, … a repeat downward spiral of the railroad industry, similar to the 1970s, could occur, with multiple bankruptcies that could cripple the transportation system."

If rail access to capital is reduced or eliminated, the only alternative is for the government to step in and provide subsidies to railroads to make up for the billions of dollars of lost revenue caused by reregulation.

Rail Customers Oppose Reregulation

I firmly believe that the overwhelming majority of railroad customers believe that railroads are meeting their freight transportation needs efficiently, cost-effectively, and fairly. I also believe that most rail customers do not support reregulation, and that many of those who have expressed support for H.R. 2924 would rethink that support if they paused to consider all the implications of the legislation.

We have concrete evidence of the fact that many shippers oppose reregulation. We asked shippers opposed to reregulation to write to Congress to express their opposition. Hundreds of shippers, large and small, have done just that. They cover the gamut of rail shippers — auto manufacturers, chemical companies, steel companies, grain companies, coal companies. Some are "singly served" and some are not.

I'd like to share a few excerpts from those letters with you:

- The Alliance of Automobile Manufacturers, a trade association whose members account for more than 90 percent of U.S. vehicle sales, wrote: "Alliance members — as major users of the rail system — view [S. 919/H.R. 2924] as an attempt to re-regulate the rail industry and undo the progress made since the Staggers Act deregulated it in 1980. We strongly urge the Committee to reject this legislation and maintain the free market system that has been beneficial for shippers and the railroads alike."
- The Port of Los Angeles, one of the largest and busiest ports in the world, wrote, "Increased efficiency and improved service …has enabled the rail industry to divert significant amounts of business from highway to the intermodal option. …None of this would have been possible without the billions of dollars that the railroads have invested in new technology and to improve locomotive and car fleets. To maintain these high standards, railroads will need to continue that level of investment in the future. However, their ability to do so may be negatively impacted by the re-regulation legislation currently being proposed….Our railroads have recovered from the serious financial troubles, including numerous bankruptcies, of the 1970s. We cannot run the risk of that happening again."
- Martco, a Louisiana lumber and forestry firm, wrote, "Senate Bill 919 is an attempt to reregulate the railroad industry. . . Initially the bulk shippers and bulk industries would perhaps benefit by the establishment of some noncompensatory rate structures. The reduced returns would have to be addressed and they would, through the passing of increased rates to the non-bulk and smaller shippers. Thus the pre-Staggers Act cycle would return: reduced rate for shipper A, must be met by increased rates or reduced service for other shippers who then will divert traffic onto our overcrowded highway system…thereby increasing logistics costs to all parties while further reducing the rail industry route structure. Soon rail rates for the few large bulk shippers would have to be increased given the absence of other traffic to spread cost and hopefully provide a return."
- The president of Schneider National — the nation's largest truckload motor carrier — wrote that if H.R. 2924 were passed, "Schneider National and its thousands of shipper-customers would suffer significantly from the loss of a cost effective and efficient intermodal rail system and would be forced to divert much of our volume onto the already crowded highway system. …We believe that additional regulation of the rail system would have a detrimental effect on the progress achieved through a free market."
- The CEO of Kokomo Grain in Indiana wrote to express "strong opposition" to S. 919/H.R. 2924, writing "[E]ven those shippers that are only served by one railroad and have limited shipping alternatives are better served by a business environment that is not hindered by re-regulation. On the whole, the deregulation of the railroad

industry in 1980…has been a positive experience for American business. I do not want to see those gains and benefits thrown aside with a move towards blanket re-regulation to fix certain competitive concerns of some shippers that would be best addressed in other fashions."

- The general manager of the Port of Montana wrote that H.R. 2924 "would significantly reduce railroad revenues by forcing upon them governmentally mandated price "competition" which the free market would not otherwise sustain. …I urge you to continue your support of the current rail regulatory structure. I believe this is the best way our company can guarantee continued access to a healthy railroad network, a network which is critical to our company's competitive success in the domestic and global marketplace."
- Chemical company Dyno Nobel wrote: "Clearly all shippers would like to reduce the rates that they pay for transportation services, but calling for re-regulation of the rail industry is remarkably short sighted and is a move that we do not support. In the long run, all rail users will be the losers because the inevitable result will be to devastate the ability of the railroads to continue providing their present level of service, much less to make vitally needed investments for the future."
- Oregon Steel Mills, one of the most diversified minimills in the United States, wrote: "[D]ue to the influence of the unregulated marketplace, rail service is safer, more reliable, more efficient, and less costly. The situation has been good, not only for the industry itself, but also for customers like Oregon Steel Mills, who use rail service extensively. We urge you to continue your support of the current rail regulatory structure."

The point is this: for every shipper who supports reregulation, there are many others who oppose it. And they oppose it because they rely on rail service and do not want to return to the failed policies of the past.

Railroad Customer Service

It is a fact of life in the rail industry that in addition to facing unrelenting competition, the service requirements of rail customers are continually becoming more stringent. Railroads recognize that service shortcomings have been a major factor behind shipper dissatisfaction in recent years, including shipper dissatisfaction that has sometimes manifested itself in calls for railroad reregulation.

I am happy to say, though, that railroads have made tremendous progress in the customer service area. This is not to deny that from time to time railroads experience service problems — as one would expect on a rail network with enough trackage to circle the globe nearly six times. When these problems occurs, railroads work diligently to resolve them, as they should. Overall, though, the U.S. freight rail system today is operating smoothly. Moreover, it is foolhardy to believe that reregulating railroads, and thereby limiting even more the amount of funds railroads have to devote to service improvements, could possibly improve rail service. Indeed, the opposite is true.

Shippers and others recognize railroad service improvements:

- In an article in the August 18, 2003 issue of Traffic World, UPS spokesman Norman Black says, "The most important thing we see from all of our rail partners is a huge commitment to customer service. They're doing a much better job. Trains are running when they say they're going to run, and arriving when they say they're going to arrive. From a UPS standpoint, that's all we want."
- In a July 25, 2003 article in The Wall Street Journal, Bill Zollars, the CEO of Yellow Corporation, one of the nation's largest trucking companies, says railroads "are more focused on the customer and growing their business than I've ever seen."
- A February 6, 2003 article in Purchasing magazine notes that "[R]ail shippers continue to report consistent efforts and improvements in the level of service they receive from carriers..."
- In a Traffic World article on rail service improvements on January 27, 2003, the rail operations manager at a major U.S. petrochemical company credits railroads with doing "an admirable job of identifying areas of concern and then addressing the problem."
- In October 2003, Burlington Northern and Santa Fe (BNSF) was named Carrier of the Year by FedEx Supply Chain Services for the second year in a row. Criteria for the award included on-time service, safety, claims/damages, communication and freight bill accuracy. In addition, in September 2003, American Honda Motor Company awarded BNSF the "Premier Partner Awar" for excellence in quality, value and customer service. BNSF was one of 15 suppliers selected out of the 74 nominated companies that service American Honda nationwide. "We are extremely pleased to honor Burlington Northern Santa Fe Railway and the other American Honda suppliers who continually provide us with invaluable services that consistently meet and exceed our expectations," said a Honda official.

- Canadian National (CN) received on-time service awards from Toyota Canada in 2003 and 2002 and was named the "Canadian Carrier of the Year" for 2002 by Quaker-Tropicana-Gatorade. In addition, CN's Wisconsin Central subsidiary was the recipient of a 2003 Quest for Quality Award, having been selected by the readers of Logistics Management as one of the Quality Carriers in the Railroads (Standard Rail Service) category.
- In April 2003, Toyota Logistics Services recognized Norfolk Southern Railway (NS) with two awards for service excellence. Toyota awarded NS a "Logistics Excellence Award" for superior quality performance among rail carriers and an on-time performance award for transportation service. NS was also named Coors Brewing Company's 2002 "Transportation Supplier of the Year," the first time NS received the award.
- In June 2003, CSX Transportation was awarded the Gold Carrier Award by Shell Chemicals for the quality of the rail carrier's overall performance in moving Shell chemicals. The award marks only the third time in the award's 10-year history that a rail carrier was so honored. A Shell official remarked that "CSXT has worked hard at becoming one of the few Gold Carrier recipients. We at Shell would like to give CSXT and its employees a well-deserved congratulation."
- In April 2003, Union Pacific Railroad (UP) was also named a recipient of Toyota's "Logistics Excellence Award." UP also earned a General Motors "Supplier of the Year" Award for 2002. A GM official remarked that UP's "performance and contributions have been critical in helping GM become the industry's low cost producer of high quality vehicles. They serve as a role model for other suppliers."
- In a recent communication, a manager at a Louisiana agribusiness firm wrote: "I have been the complex manager of Terral Farm Service in Delhi, Louisiana for ten years. Over that period of time, we have shipped thousands of rail cars with Kansas City Southern and before that with Mid South. This year, the individuals at KCS performed as well as I could ask for. The service was almost perfect."
- Canadian Pacific Railway's (CP) won the prestigious 2003 Franz Edelman Award for Achievement in Operations Research and the Management Sciences. The award, recognized as the "Tech World Series" and sought after by operations researchers and planners around the world, is presented by the Institute for Operations Research and the Management Sciences. CP won the award for its work on improved scheduling that yields significant, direct benefits to the company's customers.

Railroads and Plant Shutdowns

Proponents of H.R. 2924 have claimed that excessive rail rates will cause U.S. manufacturers to shut down their U.S. operations, either in favor of locations overseas or simply in totality. In testimony to the Senate in October 2003, for example, a representative of Consumers United for Rail Equity (a pro-reregulation group) stated that some "captive" rail shippers "will shift their manufacturing to foreign countries, exporting American jobs overseas. Some companies might be forced to close a U.S. plant or to forego an expansion without even having an offshore alternative."

The implication of this kind of statement is that a railroad would prefer to lose a (presumably profitable) customer's business entirely rather than do whatever it reasonably can to keep that customer competitive. This is, frankly, ridiculous. A railroad's management — and its shareholders, to whom the management is responsible — know full well that pricing rail movements or limiting service offerings in such a way as to make the products produced at a customer's facilities uncompetitive in the marketplace, and thereby losing that customer's traffic, is hardly in the best interest of the railroad, and it will do whatever it reasonably can to avoid it.

More broadly, in recent weeks and months there has been an even greater than usual amount of discussion in the press, in the halls of Congress, and elsewhere regarding the issue of plant shutdowns and relocations, especially overseas.

This topic is certainly complicated and controversial. Many observers point to substantially lower labor costs in foreign countries as perhaps the primary reason for the movement of plants and jobs from here to abroad. Health care costs, a component of labor costs, are themselves often cited. A March 6th, 2004 article in The Washington Post, for example, noted that "the rapidly rising cost of health care in the United States means that even developed countries have an edge when it comes to keeping jobs."[12]

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[12] Kirstin Downey, "A Heftier Dose to Swallow," The Washington Post, March 6, 2004.

Energy costs also certainly play a role. An article in The Washington Post two weeks ago notes that Dow Chemical Company has closed four major chemical factories in North America in the past two years and replaced them with production from factories elsewhere in the world. The article quotes a Dow executive as saying, "These jobs…left the U.S. because of uncompetitive energy costs."[13] It is no secret that the U.S. chemical sector especially has been hit extremely hard by the sharp increase in natural gas prices in recent years — so much so that the industry is waging a huge campaign to make the public and policymakers aware of the damage high natural gas prices are causing.

A recent study sponsored by the National Association of Manufacturers points to excessive corporate tax rates, employee benefits, tort litigation, regulatory compliance, and energy as primarily responsible for the competitive challenges facing U.S. manufacturers and their workers relative to major foreign competitors.[14]

No doubt all of these factors come into play to some degree. But there is also no doubt that U.S. freight railroads — with their remarkable efficiency and cost-effectiveness — are a source of extraordinary competitive advantage for U.S. companies and industries, not a competitive disadvantage as some would have you believe.

Indeed, the U.S. freight rail system is the envy of the world. Lou Thompson, until recently the World Bank's Railways Adviser and one of the world's foremost authorities on global railways, has stated, "Because of a market-based approach involving minimal

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[13] Greg Schneider, "Chemical Industry in Crisis," The Washington Post, March 17, 2004.

[14] Jeremy Leonard, How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness, paper prepared for The Manufacturing Institute of the National Association of Manufacturers, December 2003.

government intervention, today's U.S. freight railroads add up to a network that, comparing the total cost to shippers and taxpayers, gives the world's most cost-effective rail freight service." Moreover, due to efficiency gains made by freight railroads and other transportation providers relative to other sectors of the economy, logistics costs as a percentage of GDP have been driven down substantially in recent years.

Conclusion

The partial deregulation of U.S. freight railroads brought about by the Staggers Act has worked. Railroads have been able to upgrade their systems, reinvest hundreds of billions of dollars in productive rail infrastructure and equipment, provide higher levels of service, raise traffic volumes, dramatically increase productivity, improve profitability, and improve safety — while at the same time sharply lowering rates for shippers.

Proposals to reregulate railroads threaten all of these gains and are contrary to economic logic and sound policy. They would severely harm rail service, the shippers that rely on that service, and the national economy. They represent the legacy of failure and should be rejected.